No. 11818

In the United States Circuit Court of Appeals for the Ninth Circuit

ANNIS VAN NUYS SCHWEPPE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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CITATIONS

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 19–35) are reported in 8 T. C. 1224.

JURISDICTION

This case involves deficiencies in income tax, first asserted by respondent in the amount of $10,110.78 for 1940 and $20,605.75 for 1941 by notice of deficiency dated August 10, 1944. (R. 9–15.) Taxpayer's petition for redetermination was filed with the Tax Court within ninety days thereafter on November 4, 1944 (R. 2), pursuant to Section 272 of the Internal Revenue Code. The decision of the Tax Court finding deficiencies for the years 1940 and 1941 in the respective amounts of $10,110.78 and $14,850 was en-

tered on August 28, 1947. (R. 36.) Taxpayer's petition for review was filed on November 14, 1947 (R. 4), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

In deciding that cash distributions to taxpayer from the I. N. Van Nuys Building Company in 1940 and 1941 were dividends and not distributions from capital, did the Tax Court commit reversible error?

STATUTE AND REGULATIONS INVOLVED

The pertinent parts of the statute and Regulations are set out in the Appendix, *infra*.

STATEMENT

The facts as stipulated by the parties (R. 43–84) and as contained in the Findings of Fact and Opinion of the Tax Court (R. 19–35) may be summarized as follows:

1. *The Contemporary Facts Basing the Assessment.*—The I. N. Van Nuys Building Company is a California corporation which owns and holds the property commonly known as the Van Nuys Building located at the southwest corner of Seventh and Spring Streets in Los Angeles. (R. 21–22, 44–45). The stock of the Building Company is owned in approximately equal one-third shares by the three living children of I. N. Van Nuys and Susanna H. Van Nuys (both deceased), one of whom is the taxpayer; the others being Kate Van Nuys Page and J. B. Van Nuys. (R. 21–22, 44, 52.) In 1940, taxpayer received a cash distribution of $35,246.38 on her

Building Company stock, and in 1941 she received a similar distribution in the amount of $24,149.16. (R. 22.) On the Building Company books, these distributions were charged as follows:

	Total distributions paid	Charged "earned surplus"	Charged "reduction surplus"
1940	$35,246.38	$10,746.62	$24,499.76
1941	24,149.16	3,128.02	21,021.14

(R. 27, 51.)

In her returns for 1940 and 1941, taxpayer included as taxable dividends received only the amounts charged by the Building Company to "earned surplus" account. Respondent has added to taxpayer's income the amounts received which were charged on the Building Company books to "reduction surplus" account, and the sole issue in the case is whether or not such amounts are dividends taxable to the recipient in the years involved. (R. 27–28, 44, 50–51.)

In the years prior to and including 1937 dividends paid to the stockholders of the Building Company were charged against "earned surplus" account. In 1938 and years thereafter the distributions made to stockholders were first charged against the "earned surplus" account until that account was exhausted, and the balance was then charged against "reduction surplus" account. The "earned surplus" account included all of the Building Company's earnings and profits available for distribution to stockholders during the period in question except the amount of $400,000 reflected in "reduction surplus" account,

which, taxpayer claims, is not part of such earnings and profits. (R. 27, 50.)

2. *Origin and Nature of the $400,000 Receipt From Which Dividends Were Paid.*—The Van Nuys Building was constructed in about 1912–1913. During the course of construction Susanna H. Van Nuys, taxpayer's mother, loaned to the Building Company $400,000 on a promissory note dated March 1, 1913, payable three years after its date with interest at five percent. (R. 22, 45, 53.) The note was secured by a mortgage on the building property, dated March 1, 1913, which was never recorded. (R. 22, 46, 59–69.) I. N. Van Nuys, taxpayer's father, died February 12, 1912 (R. 45), and from January 1, 1913, to June 25, 1913, the estate of I. N. Van Nuys held 12,750 out of 13,250 shares of the Building Company's stock (R. 44, 52). Susanna H. Van Nuys and the three children then each owned about 100 of such shares. (R. 52). After June 25, 1913, Susanna H. Van Nuys owned one-half of the Building Company stock, and each of her three children, the present stockholders, owned one-sixth thereof. (R. 21, 45.) In February 1919, Susanna H. Van Nuys gave such children in equal shares all of the Building Company stock except one share, which she held until her death on May 1, 1923. (R. 22–23, 46.) Between 1915–1920, Susanna H. Van Nuys stated to various members of her family including her son, J. B. Van Nuys, who was then secretary of the Building Company, that she did not intend to enforce collection of the note. (R. 23.) She made no attempt during her lifetime to

collect the note. However, it was not surrendered to the Building Company, nor cancelled, nor was the indebtedness represented thereby gratuitously forgiven by her. (R. 23.) Interest on the note was paid semi-annually to Susanna H. Van Nuys by the Building Company up to and including December 31, 1922, but no amount was ever paid on principal and no interest was paid after December 31, 1922. The Company deducted such interest as expense on its books and income tax returns. The Company was solvent at all times. The $400,000 item was carried on the Company books as a liability until January 21, 1924, at which time it was, pursuant to a resolution of the board of directors reciting that the note "has become outlawed and is no longer enforceable", transferred to "Surplus Paid-In" account. (R. 23, 47.)

The note was returned as being of no value in the Susanna H. Van Nuys estate tax return. Respondent in 1925 tentatively determined a deficiency based on a value of $400,000 for the note. (R. 24, 47.) Thereupon, the executor of decedent's will commenced an action on the note and mortgage in the California Superior Court against the Building Company, which successfully pleaded the statute of limitations and obtained judgment on November 6, 1925, to the effect that the claim was barred. (R. 24–25, 47–48, 54–80.) A deficiency based on inclusion of such $400,000 note in the estate was nonetheless asserted (R. 25, 48), and was paid and a suit for refund was commenced in the District Court for the Southern District of California. (R. 26, 48–49.) The court held in this action that the

note should not be taxed in decedent's estate, and entered judgment in favor of the executor for a tax refund on July 18, 1929. (*Title Insurance & Trust Co. v. Welch,* 37 F. 2d 617 (~~D. C.~~ S. D. Cal.)). (R. 26, 49.)

On September 13, 1938, pursuant to resolutions of the board of directors of the Building Company, the $400,000 "Surplus Paid-In" was transferred on the Company books to "Stated Capital", and from the latter account to "Reduction Surplus" account, with provision for its distribution to shareholders from time to time as later determined. (R. 26–27, 49–50, 80–84.) The taxability as dividends of distributions from this account in 1940 and 1941 is the sole issue. (R. 21, 44.)

SUMMARY OF ARGUMENT

It is clearly taxpayer's burden to show that the amounts received by her from the Building Company in 1940 and 1941 were not taxable dividends, but return of capital. To maintain that position, taxpayer asserts that a $400,000 receipt of the Building Company, realized upon the extinction of a liability in that amount to Susanna H. Van Nuys, is not part of the Company's earnings or profits because it was a gift to the Company from Mrs. Van Nuys. Taxpayer's position involves a complete reconstruction, for present tax purposes, of the facts as reflected for tax purposes by the Building Company between 1920 and 1925. For affirmative evidence of the gift, taxpayer shows only oral statements made by Mrs. Van Nuys that she did not intend to collect. This is not sufficient, either on the element of intention or delivery, to establish a gift. Neither Mrs. Van Nuys

nor the corporation took action to consummate her (assumed) wish. On the contrary, the corporation acknowledged its obligation up to the time of the death of Susanna H. Van Nuys by paying interest regularly, and took the appropriate income tax deductions. The accretion to the corporation was realized after her death, by corporate action successfully establishing in the state and federal courts that the obligation was barred by the statute of limitations; and by the elimination of the obligation from the Company books. True, the accretion was not in the ordinary course of business, e. g., a receipt from rents; it resulted from a cost-free discharge of an obligation. Such an accretion is nonetheless economic gain to the corporation and a part of its earnings or profits, payments from which are divided to stockholders rather than return of capital.

Furthermore, the sole issue in the case turns on the evidence before the Tax Court concerning the tax nature of a receipt of $400,000 by the Company over twenty years ago, which taxpayer claims was a gift constituting capital of the corporation, and which the Tax Court, after a thorough review of the evidence, found not a gift, but an accretion to earnings or profits. The problem in the case, as the Tax Court says, "is largely one of fact." The case certainly involves no generalizing principle of law. Rather, it involves the proper characterization of a business transaction for income tax purposes, within the special competence of the Tax Court under the *Dobson* rule.

ARGUMENT

I

Taxpayer has not sustained the burden of showing that the $400,000 receipt of the Building Company was not earnings or profits of the Company

At the outset, it is abundantly clear that taxpayer has the burden of proving error in the respondent's determination in this case. The respondent's ultimate finding that taxpayer received a dividend out of earnings or profits is presumptively correct, and must be clearly overcome. *Faris* v. *Helvering,* 71 F. 2d 610, 611 (C. C. A. 9th), certiorari denied, 293 U. S. 584; *Cranson* v. *United States,* 146 F. 2d 871 (C. C. A. 9th), certiorari denied, 326 U. S. 717; *Golden State T. & R. Corp.* v. *Commissioner,* 125 F. 2d 641, 643 (C. C. A. 9th). Dividends paid in the ordinary course of business are taxable income to the recipient "in the absence of convincing evidence to the contrary." *Ayer* v. *Commissioner,* 7 B. T. A. 324, 329, affirmed, 26 F. 2d 547 (App. D. C.). There is a presumption that any corporate distribution, other than one in liquidation, is a dividend. *Rheinstrom* v. *Conner,* 125 F. 2d 790, 795 (C. C. A. 6th).

To support this burden, taxpayer has first shown that the source of the distributions in question was a $400,000 receipt of the Building Company, reflected in "Surplus Paid-In" account between January 21, 1924, and September 13, 1938, and thereafter reflected in "Reduction Surplus" account on the books of the Company. The book treatment of this receipt (e. g., in the nature of capital, or in the nature of earnings

or profits) is, of course, of no moment. *Bazley* v. *Commissioner,* 331 U. S. 737, 741; *Baboquivari Cattle Co.* v. *Commissioner,* 135 F. 2d 114, 116 (C. C. A. 9th); *Faris* v. *Helvering, supra.* Taxpayer has, however, shown that the Building Company had insufficient other earnings or profits available for distribution to its stockholders, and argues here, as in the Tax Court, that the $400,000 receipt was a gift (contribution to capital)[1] to the corporation, not constituting part of its earnings or profits. The first question, then, is as to the nature of this receipt.

In its inception, the $400,000 item was clearly a corporate obligation to Susanna H. Van Nuys, secured by note and mortgage dated March 1, 1913. (R. 22.) Judging by the actual happenings during the period 1913 through 1923, it was a corporate obligation until the death of Mrs. Van Nuys. The note and mortgage existed during that period, unsurrendered and uncancelled; the indebtedness to Mrs. Van Nuys remained unchanged on the corporate books as a liability; interest at five per cent was paid by the Company semi-annually to Mrs. Van Nuys through December 31, 1922 (last payment due before her death on May 1, 1923) *and was deducted as expense on the Company books and income tax returns.* (R. 23.) The loan from Mrs. Van Nuys was carried as a liability on the books until January 21, 1924. The tax benefit to this

[1] The nominal holding of Mrs. Van Nuys in the Building Company (one share) during the years in question was an insufficient proprietary interest to support a contention that she made a "contribution to capital." *Cf. George Hall Corp.* v. *Commissioner,* 2 T. C. 146, 147.

"family corporation" (Pet. Br. 11) from the facts as then reflected is clear and unquestioned; as taxpayer says (Br. 34):

> The normal tax on corporations during the years 1921 and 1922 was 10% and 12½% respectively, whereas, the normal tax for individuals for these years on a taxpayer in the brackets of Susanna H. Van Nuys was 8%. Revenue Act 1921, Sections 210 (a) and 230.

Taxpayer now finds it advantageous to ask the Court for a 1948 reconstruction of the 1920 facts, asserting (Br. 32–35) that the obligation was really outlawed by the statute of limitations on March 1, 1920, and interest payments thereafter "dividends to Mrs. Van Nuys, or dividends to the children and gifts by them to her." A long course of dealing, and $60,000 of interest paid and deducted by the Building Company, are, under taxpayer's claim, to be reconstructed now in support of the theory that the $400,000 receipt was a gift in 1920 to the Company. The principle of *Burnet* v. *Commonwealth Imp. Co.*, 287 U. S. 415, 419, is clearly applicable, that having enjoyed the benefits which resulted from carrying the obligation as such on the corporate books, the stockholder is in no position to urge that transactions as reflected thereon were otherwise "in substance"; and that taxpayer, a participant in the 1920 arrangements, must accept the present tax disadvantages. *Cf. Moline Properties* v. *Commissioner,* 319 U. S. 436, 439. It is the Government, not the taxpayer, who "may look at actualities and upon determination that the form employed for doing business or carrying out

the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute." *Higgins* v. *Smith,* 308 U. S. 473, 477.

Again, judging by what actually happened, the Building Company was freed of its legal obligation by legal action taken after the death of Mrs. Van Nuys. Her estate returned the Building Company obligation as without value for federal estate tax purposes. On September 17, 1925, a tentative deficiency was asserted by respondent based in part on a value of $400,000 for the note. On October 28, 1925, the Title Insurance and Trust Company commenced action on the note in the California Superior Court. (R. 24.) On October 30, 1925, the Building Company filed its answer, specifically pleading the statute of limitations as the sole defense to the suit. (R. 24, 70–73.) On November 6, 1925, the Court found the note and mortgage barred by such statute "as set forth in the defendant's answer herein." (R. 76, 78.) This finding was sustained, despite expressed uncertainty, by the District Court in a suit for taxes paid on the value of the note. *Title Insurance & Trust Co.* v. *Welch*, 37 F. 2d 617, 618. (S. D. Cal.) In neither action was there any assertion that the $400,000 was a gift, or a contribution to capital, during Mrs. Van Nuys' lifetime.

For proof of a gift, taxpayer relies on family discussions between 1915 and 1920, in which Mrs. Van Nuys stated "that she did not intend to enforce the collection of the note." (R. 23.) The proof on taxpayer's claim of a consummated gift to the

corporation goes no farther, except for negative facts such as the failure of Mrs. Van Nuys to mention the note in her will, and "inactivity", which despite taxpayer's claims (Br. 30–33), certainly form no adequate basis for affirmative inferences. In *Botchford* v. *Commissioner,* 81 F. 2d 914, 916 (C. C. A. 9th), this Court in an employer-employee compensation case stated the California requisites for a completed gift: donor's intent, delivery, and acceptance; and also stated the general rule that there is no presumption in favor of a gift, but the burden of proving a gift is upon the donee. In *Helvering* v. *Amer. Dental Co.*, 318 U. S. 322, 323, strongly relied on by taxpayer, the evidence showed a closed and completed transaction of gift in 1937, by the creditor's forgiveness in that year of a portion of back rent and acceptance of a reduced amount, and appropriate book entries in the same year reflecting the gift made. Taxpayer cites no authorities holding that oral statements such as those here relied on are sufficient to prove either a consummated gift, or a contribution to capital.

The book treatment of the item for corporate and tax purposes reflected not a gift but an obligation, until after the death of Mrs. Van Nuys on May 1, 1923. There was no modification of the terms of the note and mortgage by contract in writing, or by executed oral agreement, within Section 1698 of the California Civil Code (Deering, 1937 ed.); nor was there an extinction of the obligation by destruction or cancellation of the written contract, within Section

1699 of the same Code. Assuming that a general purpose to cancel the obligation existed, Mrs. Van Nuys did not in fact carry her desires into action, and as the Tax Court succinctly puts it (R. 32):

> The very fact that interest was paid by the corporation each year on the note to Mrs. Van Nuys and that the corporation continued to carry it upon its books as bills payable shows that she had not in fact forgiven the indebtedness and had not made a capital contribution of it to the corporation. * * * Moreover when the executor of the estate of Susanna H. Van Nuys brought an action on the note in the California court and the Building Company pleaded only the statute of limitations as a defense we think it indicated that the parties believed in the existence of the debt. There was no claim in that suit that Mrs. Van Nuys had forgiven the indebtedness to the Building Company during her lifetime.

At most, then, we have an unexecuted desire—an unconsummated wish—on the part of Mrs. Van Nuys, to benefit the Building Company or her children. It is sufficient answer to taxpayer's "form-substance" argument (Br. 38–46) that on looking through "form" we find certain action taken, and certain action foregone during the period in question, with tax consequences then reflected in accordance with the facts. In determining the effect of a transaction for tax purposes the courts consider what was actually done and not what might have been done. *United States* v. *Phellis,* 257 U. S. 156; *Remington*

Rand, Inc. v. *Commissioner,* 33 F. 2d 77 (C. C. A. 2d), certiorari denied, 280 U. S. 591; *Eaton* v. *White,* 70 F. 2d 449 (C. C. A. 1st); *Clemmons* v. *Commissioner,* 54 F. 2d 209 (C. C. A. 5th).

It is certain that the Building Company realized, at some time more than twenty years ago, a receipt of $400,000. Taxpayer earnestly contends (Br. 11–13) that the non-recurring, "unearned" character of the receipt, and the fact that it did not result from corporate operations (i. e., rents) should by definition take the receipt out of the category of "earnings or profits", citing (Br. 15–20) various accounting concepts of this term. However, "earnings or profits", in the tax sense, does not necessarily follow corporate accounting concepts. *Commissioner* v. *Wheeler,* 324 U. S. 542, 546. A variety of receipts non-recurring in character are plainly "earnings or profits", e. g., from life insurance proceeds (*Cummings* v. *Commissioner,* 73 F. 2d 477 (C. C. A. 1st)), and the proceeds from the cancellation of indebtedness, which is "included in earnings, not merely because it operates to make available to the stockholders a larger amount for the payment of dividends, but because it constitutes a profit in the generally accepted sense of the word." Rudick, "Dividends" and "Earnings or Profits" Under the Income Tax Law, 89 U. of Pa. L. Rev. 865, 883 (1941). On the facts as reflected by the Building Company and the Van Nuys family, including taxpayer, during the period in question, the receipt was no more and no less than a cost-free cancellation of corporate indebtedness, or extinguishment

of corporate obligation. As the Tax Court found (R. 34):

> When the corporation was relieved of the debt of $400,000 its free assets were correspondingly increased. This enhancement was due to the judgment of the California court in the suit on the note brought by the executor of the estate of Susanna H. Van Nuys wherein the court upheld the contention of the Building Company that the statute of limitations in effect in California was a bar. It was not until the judgment of the California court that the right of the note-holder was finally determined because the only defense to the payment of the note was the plea of the bar of the statute of limitations which must be affirmatively pleaded and could have been waived. * * * By virtue of the judgment of the California court the amount of $400,000 was released to the general uses of the Building Company and its assets, previously offset by the obligation of the note, were made available to the Building Company. This benefit, we think, is "earnings and profits" within the meaning of section 115 (a). * * *

The Tax Court citations to this finding include: *United States* v. *Kirby Lumber Co.,* 284 U. S. 1, 3 (purchase of bonds at less than par makes assets available which were previously offset by obligations, and this is an accession to corporate income); *Helvering* v. *Amer. Chicle Co.,* 291 U. S. 426, 430 (discharge of liability for less than par results in taxable income); *Walker* v. *Commissioner,* 88 F. 2d 170 (C. C. A. 5th), certiorari denied, 302 U. S. 692 (release of partner's indebtedness occurred in 1930 when

account was credited and note surrendered, and constituted taxable income then, not in prior year of "agreement").

It is well recognized that a corporation may realize taxable income as a result of the running of the statute of limitations on a corporate liability, or lapse of time indicating unlikelihood of collection by the creditor. *Chicago, R. I. & P. Ry. Co.* v. *Commissioner,* 47 F. 2d 990, 992 (C. C. A. 7th), certiorari denied, 284 U. S. 618; *Charleston & W. C. Ry. Co.* v. *Burnet,* 50 F. 2d 342 (App. D. C.); *North American Coal Corp.* v. *Commissioner,* 97 F. 2d 325 (C. C. A. 6th); 2 Mertens, Law of Federal Income Taxation, Section 11.26.

Moreover, in the present case, while it seems clear enough that income was similarly realized by the Building Company, the decision below may be supported on a further ground.[2] The statutory concept

[2] The distinction between taxable income of a corporation and earnings or profits of a corporation available for distribution is well stated in *Ayer* v. *Commissioner*, 12 B. T. A. 284, 287, as follows:

"* * * some income or profit free from tax in the hands of a corporation is, nevertheless, taxable to a stockholder upon distribution. Dividends and stock of domestic corporations, interest on bonds and obligations of States and municipalities, and statutory exemptions are not a part of the statutory net income of a corporation, but are nevertheless a part of its earnings or profits and may form a part of ordinary dividends which are taxable when received by the stockholders. * * *"

No cases are found supporting taxpayer's thought that "earnings or profits" does not include all income items. Of course, expenses or losses which are not allowed as deductions in computing taxable net income, but which clearly deplete the income available for distribution to the stockholders "* * * must be deducted in computing earnings or profits." Rudick, *op. cit. supra*, p. 887.

of "earnings or profits" is not limited to "income" items; and payments from funds traceable to tax-free receipts are often taxable dividends because the receipts are earnings or profits. Thus, in the *Cummings* case, *supra,* the life insurance proceeds were distributed pursuant to resolutions, where the evidence "plainly" showed that such receipts were intended to benefit the stockholders. The Court, however, held the distributions to be from Section 115 (a) earnings or profits, and said (p. 480):

> "Earnings or profits" as used in this section must mean the same as "gains or profits" in section 22 (a), and a gift to a corporation would be a gain. Nor would it be overstating the transaction here to say that the company having invested in the insurance policies by paying the premiums, the receipts therefrom over and above the premiums were profits. If these funds, however derived, belonged to the company where received, they would go to increase its surplus, and it cannot be seriously argued that the surplus funds in the hands of the company over and above its stock liability are not the earnings or profits contemplated by the section.

See also, Paul, Ascertainment of "Earnings or Profits" for the Purpose of Determining Taxability of Corporate Distributions, Selected Studies in Federal Taxation (Second Series), pp. 149–199. A gift to a corporation, though not income, might well be considered "earnings or profits", since the Section 22 (b) (3) statutory exemption of gifts from gross income is an exemption "granted to the corporation,

not to its stockholders", the corporation being "not merely a conduit" and the identity of the gift being "lost in the distribution". Rudick, *op. cit. supra,* p. 881. As the Court observed in *Helvering* v. *American Dental Co., supra,* pp. 329–330, citing cases, "the broad import of gross income in Section 22 (a) admonishes us to be chary of extending any words of exemption beyond their plain meaning."

This issue, however, is not presented in the present case, because the facts do not establish a consummated gift from Mrs. Van Nuys to the Building Company. The failure of taxpayer to establish such a gift in the present case makes it unnecessary to consider *United States* v. *Oregon-Washington R. and Nav. Co.,* 251 Fed. 211 (C. C. A. 2d); *Helvering* v. *American Dental Co., supra; American Cigar Co.* v. *Commissioner,* 66 F. 2d 425 (C. C. A. 2d), certiorari denied, 290 U. S. 699, and similar cases cited by taxpayer, in all of which clear and definite steps were taken to consummate gifts, or capital contributions. The present facts show a not unusual type of economic gain realized by the Building Company, normally and conventionally held to be taxable income in nature, and an accession to earnings or profits. It makes no present difference whether the $400,000 receipt was realized in 1920, when the statute of limitations ran on the obligation; in 1924, when the liability was removed from the Company books; or in 1925, when the California court held the obligation barred by the statute of limitations.

II

The Tax Court determination is one of fact, and of tax accounting, with warrant in the record. It is not further reviewable

The review of the record and the statement of the issue in connection with Point I, *supra,* sufficiently defines the problem of this case as one turning only on the evidence before the Tax Court concerning the tax nature of a $400,000 receipt by the Building Company over twenty years ago. Taxpayer, before the Tax Court, unsuccessfully stressed certain circumstances tending to indicate that the receipt was a gift, or a contribution to capital, and brings the same argument to this Court. There are numerous other circumstances looking the other way, and it is the function of the Tax Court to choose. *Wilmington Co.* v. *Helvering,* 316 U. S. 164, 167–168. The Tax Court has specifically found (R. 31) that the problem in this case "is largely one of fact."

In *Commissioner* v. *Estate of Bedford,* 325 U. S. 283, the Tax Court had held (1 T. C. 478) that a corporate distribution of cash pursuant to a tax-free recapitalization was out of earnings and profits (despite book surplus deficit), and taxable as a dividend rather than as a capital gain. The Second Circuit reversed (144 F. 2d 272). In reinstating the Tax Court determination, the Supreme Court said as to the substantive issue in the case (p. 292):

> * * * the matter is not wholly free from doubt. But these doubts would have to be stronger than they are to displace the informed

> views of the Tax Court. And if the case can be reduced to its own particular circumstances rather than turn on a generalizing principle we should feel bound to apply *Dobson* v. *Commissioner,* 320 U. S. 489, and sustain the Tax Court.

See also, *Bazley* v. *Commissioner, supra,* where the Court affirmed a determination that debentures distributed were a dividend taxable as earned income under Sections 22 (a), 115 (a) and (g) of the Code, finding no "misconception of law" involved in the case.[3]

It is the function of the Tax Court to "examine relevant facts of business to determine whether or not they come under statutory language" (*John Kelley Co.* v. *Commissioner,* 326 U. S. 521, 529), and the Tax Court's determination should be accepted unless it involves a "clear-cut question of law" (*id.,* p. 527). Nor should the Tax Court's decision be disturbed by "treating as questions of law what really are disputes over accounting." *Dobson* v. *Commissioner,* 320 U. S. 489, 499.

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[3] In the Third Circuit Court of Appeals decision in *Bazley* v. *Commissioner*, *supra*, reported in 155 F. 2d 237, the court refers to the Tax Court's decision that a certain distribution was out of earnings and profits as a "factual conclusion" (p. 241). And in *Adams* v. *Commissioner*, 155 F. 2d 246, 248 (C. C. A. 3d), affirmed, 331 U. S. 737, with *Bazley* v. *Commissioner*, *supra*, the Third Circuit speaks of a similar question, whether a certain distribution was essentially equivalent to a taxable dividend, as follows:

"In the last analysis, this case turns on a dispute over proper accounting procedure for income tax collection purposes. We are not at liberty to treat as a question of law such a dispute. It is patently controlled by the Dobson rule."

As in *Wilkins* v. *Commissioner,* 161 F. 2d 830, 832–833 (C. C. A. 1st), the taxpayer in the present case "contends in substance that the Tax Court erred in its characterization of a business transaction for income tax purposes." This presents no clear-cut question of law, but the question of classification of the given transaction for tax purposes, turning on its own facts. See also, *Clark* v. *Commissioner,* 162 F. 2d 677, 680 (C. C. A. 8th), and *Kirschenbaum* v. *Commissioner,* 155 F. 2d 23, 24 (C. C. A. 2d), certiorari denied, 329 U. S. 726, where the *Estate of Bedford* rule was applied to a determination of the Tax Court that a certain redemption of stock was equivalent to a dividend—despite Second Circuit precedents to the contrary—because "a plainly erroneous legal proposition does not emerge from the record."

The present case, as in *Seattle Brewing Co.* v. *Commissioner,* 165 F. 2d 216 (C. C. A. 9th), and the companion case of *Commissioner* v. *Rainier Brewing Co.,* 165 F. 2d 217 (C. C. A. 9th)—

> * * * presented to the Tax Court "hybrid questions of mixed law and fact [and] their resolution because of the fact element will * * * afford little concrete guidance to future cases." We hence do not consider the petitioner's contention that "the facts found fall short of meeting statutory requirements." * * * [citing *Trust of Bingham* v. *Commissioner,* 325 U. S. 365, 370, and *Choate* v. *Commissioner,* 324 U. S. 1].

Rehearing was sought in the *Seattle Brewing Co.* case because "the Tax Court did no more than construe the terms of an undisputed contract," and was denied because factual inferences "were an essential part of the adjudicating process of the Tax Court in reaching its decision." *Seattle Brewing Co.* v. *Commissioner,* decided February 18, 1948 (1948 P–H, par. 72, 373). Rehearing was sought in the *Rainier Brewing Co.* case "because the probative facts relied upon by the Tax Court are undisputed," and was likewise denied; this Court stressing the "rule of general applicability" requirement of *Trust of Bingham* v. *Commissioner,* 325 U. S. 365; *John Kelley Co.* v. *Commissioner, supra; Boehm* v. *Commissioner,* 326 U. S. 287, and *Commissioner* v. *Scottish American Co.,* 323 U. S. 119. *Commissioner* v. *Rainier Brewing Co.,* decided February 18, 1948 (1948 P–H, par. 72, 372).

See also, *Wilcox* v. *Commissioner,* 137 F. 2d 136, 138 (C. C. A. 9th); *Hirsch* v. *Commissioner,* 124 F. 2d 24, 28 (C. C. A. 9th); *Botchford* v. *Commissioner, supra.*

CONCLUSION

The decision of the Tax Court should be affirmed.

Respectfully submitted.

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APRIL 1948.

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from * * * dividends * * *

* * * * *

(e) *Distributions by Corporations.*—Distributions by corporations shall be taxable to the shareholders as provided in section 115.

* * * * *

(26 U. S. C. 1940 ed., Sec. 22.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28,

1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(d) [as amended by Sec. 214 (b) of the Revenue Act of 1939, c. 247, 53 Stat. 862] *Other Distributions from Capital.*—If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913, and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. This subsection shall not apply to a distribution in partial or complete liquidation or to a distribution which, under subsection (f) (1), is not treated as a dividend, whether or not otherwise a dividend.

(26 U. S. C. 1940 ed., Sec. 115.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.115–1. *Dividends.*—The term "dividend" for the purpose of Chapter 1 (except when used in sections 203 (a) (3) and 207 (c) (1) thereof) comprises any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of either—

(1) earnings or profits accumulated since February 28, 1913, or

(2) earnings or profits of the taxable year computed without regard to the amount of the earnings or profits (whether of such year or accumulated since February 28, 1913) at the time the distribution was made.

The earnings or profits of the taxable year shall be computed as of the close of such year, without diminution by reason of any distributions made during the taxable year. For the purpose of determining whether a distribution constitutes a dividend, it is unnecessary to ascertain the amount of the earnings and profits accumulated since February 28, 1913, if the earnings and profits of the taxable year are equal to or in excess of the total amount of the distributions made within such year.

* * * * *

SEC. 19.115–2. *Sources of Distributions in General.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings and profits to the extent thereof and from the most recently accumulated earnings and profits. * * *

* * * * *

SEC. 19.115–3. [as amended by T. D. 5024, 1940–2 Cum. Bull. 110, 112; T. D. 5059, 1941–2 Cum. Bull. 125–126] *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while more bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such

basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204 (b) (5) and which is segregated accordingly in the unearned premium reserve.

Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) or corresponding provisions of prior Revenue Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 19.115–12). Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

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